Internal Revenue Service

memorandum

CC:TL-N-3558-88
Br4:KAAqui

date: APR 29 1988

to: District Counsel, Seattle CC:SEA

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your memorandum of February 12, 1988, wherein you apprised us of the substance of a telephone conference between the court and counsel for the parties in the above-referenced cases. Therein, you also requested technical advice concerning concession of the phosphate depletion issue in light of the court's holding in Monsanto Co. and Subs. v. Commissioner, 86 T.C. 1232 (1986), and the expert report prepared by [redacted] for respondent in litigating these cases.

ISSUE

Whether, due to the special circumstances of this case, concession that petitioners are entitled to treat a portion of its carbon costs as a mining cost is proper. 0613.02-07

CONCLUSION

In light of the conclusions reached by [redacted] in his preliminary report and the Service's inability to adequately prepare a rebuttal due to time constraints, we have no objection to your concession of the issue for the taxable years before the court.

DISCUSSION

Revenue Ruling 84-36, 1984-1 C.B. 143, considered in [redacted], G.C.M. 39132, I-265-79 (Dec. 9, 1983), holds that neither the cost nor value of carbon monoxide gas produced during a nonmining process is considered a mining cost and a

reduction of nonmining costs when that gas is used as fuel in a mining process for purposes of the proportionate profits computation. The publication of this revenue ruling was in response to a request for technical advice from [redacted] on whether some of its carbon costs may be allocated to a mining process (kiln) because the carbon monoxide gas produced in a nonmining process (furnace) was piped over to the kiln.

The adverse decision of the Tax Court in Monsanto Co. and Subs. v. Commissioner, 86 T.C. 1232 (1986), generated grave concerns within the Service. Although the "cost of carbon" was the sole issue decided, the rationale of Monsanto, it was argued, could be applied to the entire cost of operating the furnace. Thus, a taxpayer could increase its mining costs (and decrease its nonmining costs) by utilizing what the Service believes is a waste by-product. In O.M. 20081, CC:I-125-86 (May 27, 1987), it was determined that while no appeal would be filed from the Monsanto decision, the substituted fuel method of allocation was unreasonable.

The preliminary report prepared by [redacted] agrees with the Monsanto court that an allocation of the "carbon costs" is permissible under current accounting procedures and that the petitioners' method of allocation is reasonable. These conclusions are adverse to the position respondent would like to urge in litigation.

T.C. Rule 143(f) provides that any party who calls an expert witness shall cause that witness to prepare a written report for submission to the court and to the opposing party. If not furnished earlier, each party who calls any expert witness shall furnish to each other party, and shall submit to the court, not later than 15 days prior to the call of the trial calendar on which the case shall appear, a copy of all expert witness' reports prepared pursuant to this provision. Mr. Summers has apprised us that the court has indicated that notwithstanding T.C. Rule 143(f), it was inclined to require disclosure of [redacted]'s preliminary report.

On March 25, 1988, a meeting was held in the National office to discuss the handling of these cases. Present at the meeting were Messrs. Hadfield, Burghart and Makurath of the Corporation Tax Division, Messrs. Aqui and Miscavich of the Tax Litigation Division and Mr. Summers and Ms. Pearson. It was concluded that if the concerns expressed by the Natural Resources Branch did not change the conclusion of the preliminary report, the likelihood of success in litigation would be minimal. All the concerns expressed with respect to [redacted]'s report were subsequently communicated via a telephone conference call with [redacted] and [redacted]. [redacted] concluded that none of those concerns would have any impact on the conclusions

reached in his report but he agreed to meet with representatives of the Corporation Tax Division at a convenient time.

Our opinion is grounded on what we believe would be overwhelming litigating hazards. Nevertheless, we have grave concerns with respect to the response of [redacted] to two questions. First, [redacted] indicated that because the carbon used by taxpayer benefitted both nonmining and mining processes, an allocation of its cost was appropriate under acceptable accounting methods. He was asked why the converse was not acceptable, i.e., should not mining costs which benefit nonmining processes be similarly allocated. His response could be characterized as essentially circumlocution. Second, [redacted] stated that it would be appropriate under the substituted-fuel method to allocate to the mining process a cost in excess of the carbon costs actually incurred by the taxpayer. In our opinion, his conclusion may be valid from an accounting perspective but does critical harm to the depletion concept which is based on costs actually incurred by the taxpayer. Thus, the substituted fuel method exalts accounting principles over the "incurred costs" requirement of the regulations and is therefore unreasonable.

Nevertheless, prosecution of the instant cases would require the Service to impeach its own expert; a task which, while not insuperable, is clearly prejudicial to our interests. In a telephone call with Ms. Pearson on April 26, 1988, we were advised that you had conceded the issue that petitioners method of allocation was reasonable. Based on the foregoing, we have no objection to your disposition of these cases through concession.

If you have any question concerning this matter, please contact Mr. Keith A. Aqui at 566-3308.

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